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MEMBER BANK BORROWING AT THE FEDERAL RESERVE

By

Calvin C. Wilson

B. S. Montana State University, 1961

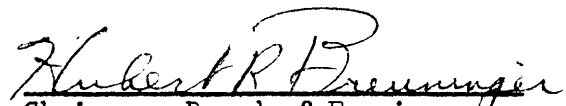
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Master of Business Administration

University of Montana

1966

Approved by:

  
Chairman, Board of Examiners

  
Dean, Graduate School

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Date

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## Chapter One

### INTRODUCTION

There are seven principal forms of credit control in the field of Federal Reserve policy:<sup>1</sup>

- 1) Tradition against borrowing
- 2) Discount rate
- 3) Open-market operations
- 4) Direct dealing with individual banks
- 5) Publicity
- 6) Changes in reserve requirements
- 7) Changes in margins on loans to carry securities

Federal Reserve Policy is a major determinant of action taken by commercial banks regarding adjustments to their reserve position, changes in loan policy, the prevailing interest paid and charged, the make-up of their asset portfolio and so on. Although all seven controls have effects in varying degrees on member bank borrowing, only the tradition against borrowing and the Federal Reserve discount rate are discussed at any great length here. Recent changes have increased the reserve requirements of member banks and have tightened the money market even more and might to some extent affect the borrowing habits of member banks. Usually the changes in reserve requirements have been so gradual as to occasion little measurable effect on member bank borrowing, although indirectly they must add to the pressure on those who must decide what stand to take regarding borrowing from the Federal Reserve.

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<sup>1</sup>W. Randolph Burgess, The Reserve Banks and the Money Market, Revised, New York: Harper & Brothers, 1946, p. 231.

It is the intent of this paper to analyze to some extent the practices of member banks of the Federal Reserve System regarding their utilization of Federal Reserve Bank credit, the techniques involved in borrowing, the tradition regarding borrowing, the effects of the prevailing financial atmosphere and other associated relevancies.

Rules governing borrowing from the Federal Reserve banks are given in the body of Regulation A of the Board of Governors of the Federal Reserve System. This paper will not reiterate Regulation A but will, instead, discuss the history of member bank borrowing; it will attempt to explain why banks borrow, to explain the present discount policy and eligibility requirements, and to make some recommendations for future action and policy in this area.

To borrow from the Federal Reserve Banks, a member bank must pledge certain collateral defined by the Board of Governors to be "eligible for discount" and pays interest on that loan at the prevailing Federal Reserve discount rate.

There have been two theories advanced which attempt to explain why banks borrow: the "profit" theory and the "need" theory.<sup>2</sup>

The basis of the "profit" theory is that banks will borrow only when it is profitable to do so. When the open-market rate on short-term government securities is above the discount rate, a bank with a reserve deficiency will tend to keep the securities and borrow from the Federal Reserve. The profit comes from retaining higher yielding securities while borrowing is relatively cheap.

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<sup>2</sup>G. Walter Woodworth, The Money Market and Monetary Management, New York: Harper & Row, 1965, p. 243.

The "need" theory is derived from a line of reasoning which says that banks won't borrow unless they have to and even then will repay the loan as soon as they're able. With this theory the discount rate involved is irrelevant, and the banks tend to borrow and pay back quickly regardless of the rate they must pay.

The need theory is further supported by a strong tradition against borrowing which probably dates back to the early years of this country; it is similar to the taboo years ago against an individual incurring personal debt. The similarity stops there since in more recent years the typical individual in this country has almost eagerly accepted personal debt to obtain his more fanciful desires. Banking on the other hand has been more conservative towards changing tradition, and indeed still retains a strong sentiment against borrowing. An examination of financial statements of banks at year-end should indicate that banks generally prefer not to disclose major indebtedness to the public; and probably rid themselves of these debts prior to statement time.<sup>3</sup> This might suggest that bankers themselves are not adverse to borrowing but that they don't want their indebtedness to become public knowledge.

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<sup>3</sup>Chart 4, Average Monthly Borrowings of Member Banks, supports this theory in that the lowest months for borrowing by member banks as indicated in 1965 was November through January, the typical statement time.



## Chapter Two

### HISTORICAL SKETCH OF BORROWING

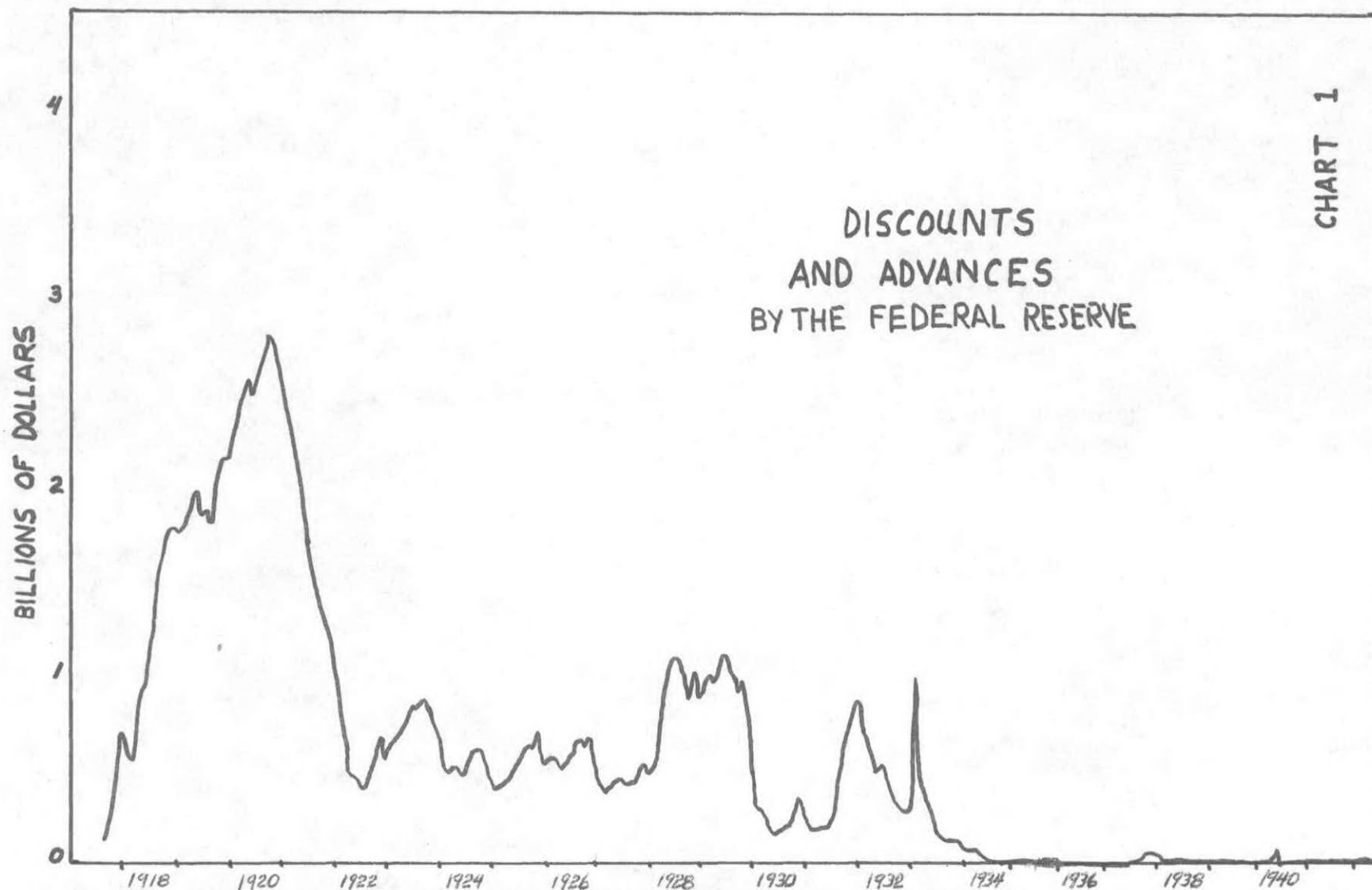
In the early years after the Federal Reserve Act the mode of thinking was about the commercial banking theory; that is, that the only safe way to lend money was to make self-liquidating loans. A self-liquidating loan is one which generates funds to pay the loan through the use made of the money borrowed. Money loaned to a farmer to put in a crop is a self-liquidating loan, since payment will come only after the crop is harvested.

Chart 1 indicates that, for the first couple of years, borrowing from the Federal Reserve was light. This was partly due to unfamiliarity on the part of the banks with the discount mechanism, but more largely due to lack of need for borrowing.

To overcome some of the difficulties associated with discounting eligible paper, the Federal Reserve Act was revised in 1916 to permit the use of government securities as collateral.

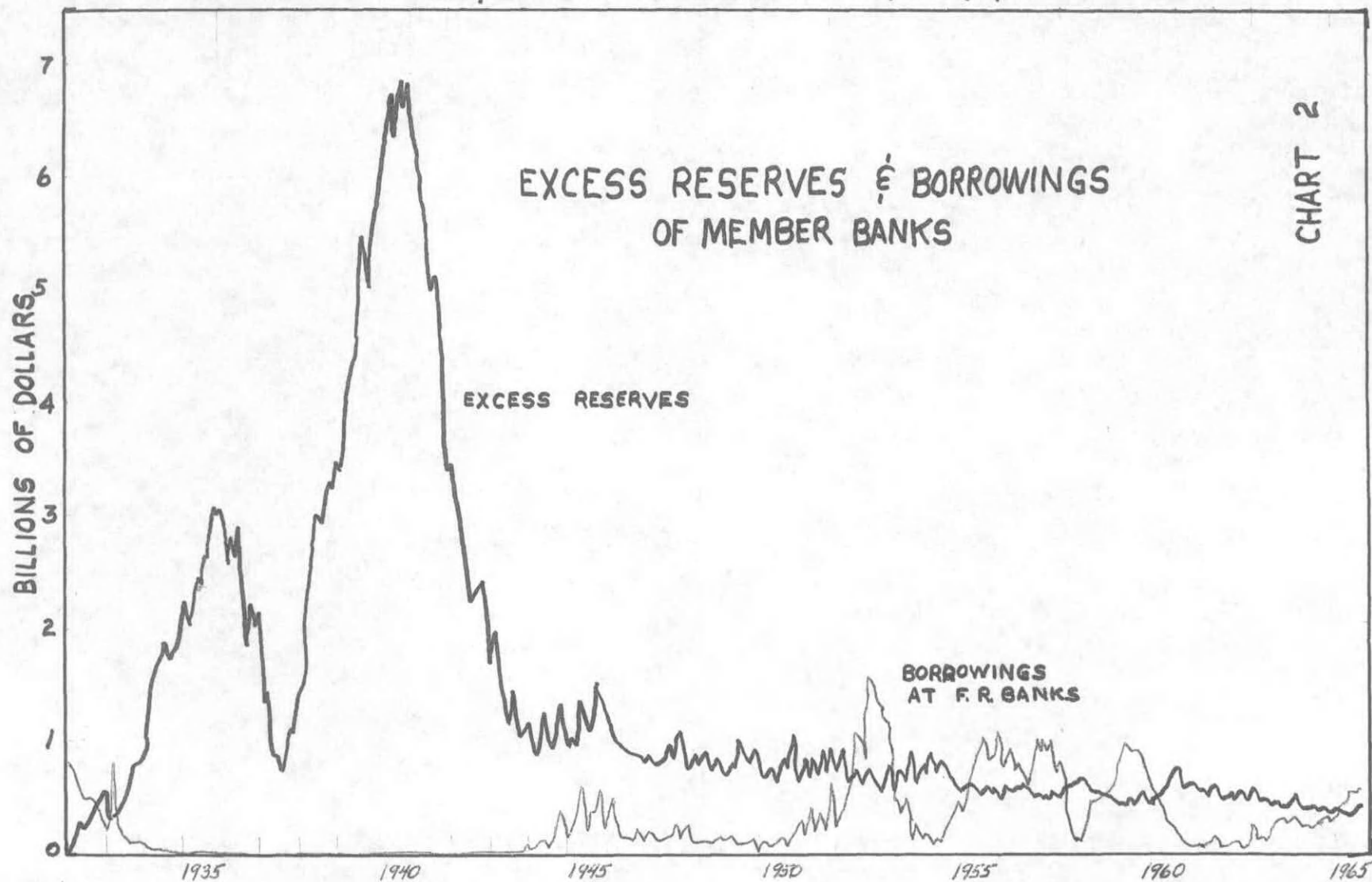
Preferential discount rates were introduced during World War I to banks using Government securities as collateral for loans; this led to a marked increase in reserve borrowings and made U. S. securities a more popular item, too. As indicated in Chart 1, total discounts and advances outstanding reached nearly 3 billion dollars by the end of 1920. Although this total declined sharply by 1922, discounts and advances remained rather substantial through the early years of the depression. Most banks either ran low on eligible collateral in the early 30's or had had such unhappy experiences associated with borrowing that a substantial part of the borrowing had subsided by 1933.

# DISCOUNTS AND ADVANCES BY THE FEDERAL RESERVE



SOURCE: HISTORICAL CHART BOOK, BOARD OF GOVERNORS OF F. R., 1965, p. 4

SOURCE: HISTORICAL CHART BOOK, BOARD OF GOVERNORS OF F. R., 1965, p. 6



Investments in U. S. Government securities by commercial banks took their first major upswing towards the end of World War I as indicated in Chart 6.

With the war financing virtually complete, several Federal Reserve banks raised the discount rate by steps to a maximum of 7 percent in an attempt to curb the growing credit expansion.<sup>4</sup> When the march of inflation continued, Federal Reserve authorities took more direct action by warning individual member banks against further credit expansion and trying to encourage them to reduce or liquidate their borrowings. "Prices broke sharply in the spring of 1920, but discounting continued at high levels through 1920, and the Federal Reserve continued to apply direct pressure into 1921 to reduce borrowings."<sup>5</sup>

One form of direct pressure tried by some Federal Reserve districts was progressive interest rates; once a member bank's borrowings exceeded a certain "basic line" --which was determined individually for each bank--interest rates rose sharply for any additional borrowing. Progressive interest rates were repealed when the Reserve Act was revised in 1923.<sup>6</sup>

Discounts declined as open market operations became more widely understood and the purchase and sale of securities assumed a major portion of the manipulation of bank reserves by 1930.

Credit policy in 1924 was directed toward international cooperation in re-establishing exchange stability. There was a rather widespread idea

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<sup>4</sup>Chart 3 indicates that the Federal Reserve discount rate reached an all-time high of 7 percent in mid-1920 and it remained at that rate until early 1921.

<sup>5</sup>George W. McKinney, Jr., The Federal Reserve Discount Window, New Brunswick, New Jersey: Rutgers University Press, 1960, p. 14.

<sup>6</sup>Ibid., p. 16.

during this period that discounting different types of paper would have different effects; it was thought that discounting acceptances would achieve the desired results most satisfactorily and acceptances were therefore given a preferred rate. The only consequence of that action was that the majority of the discounted paper was acceptances.

In 1929 an attempt was made to control the type of paper discounted at the Federal Reserve banks.

The Great Depression showed the fallacy of the commercial loan theory. As people rushed to withdraw their deposits and consumers and businesses cut back their spending, the economy came to a halt. Businesses who normally would have sold their inventories, found they had stores on hand that they couldn't get rid of, or could sell only at substantial losses. These self-liquidating loans lacked liquidity at the very time they were supposed to be liquid to keep the economy moving.

Banks became short of eligible collateral and couldn't borrow from the Federal Reserve. Consequently many banks were forced to close their doors due to lack of liquidity; these banks often times had perfectly sound assets on the books and many later paid off 100 cents on the dollar despite the adverse conditions which forced them to liquidate.

As the quality of eligible paper deteriorated, all Federal Reserve banks except San Francisco began requiring excess collateral. This requirement intensified the poor liquidity of the members since it tied up assets which might have been used to secure other forms of borrowing to meet the demands of depositors.

In 1932, section 10 (b) was added to the Federal Reserve Act and provided that the Reserve banks could lend to members on notes secured "to the satisfaction"

of the Reserve bank but at a rate 1 percent above the rate on loans secured with government securities or by eligible paper.<sup>7</sup> Furthermore all eligible paper had to be exhausted. The banking act of 1935 made section 10 (b) permanent but revised it so that all eligible paper need not be exhausted before borrowing under 10 (b) and changed the rate differential from 1 percent to 1/2 percent.

During World War II, the Federal Reserve was committed to provide the Government with low-cost sources of funds. The war was financed by enough Federal Reserve credit to enable the Government to borrow more than 200 billion dollars.<sup>8</sup> The Federal Reserve Board stood ready to buy U. S. Government securities at or above par--at a 2 1/2 percent interest rate on long-term bonds and lower rates on shorter term issues.<sup>9</sup> This meant that the Government securities held by member banks was as liquid as cash reserves, since they could be converted to cash at or above par at any time.

During this period the discount rate was set at a nominal 1 percent and a preferential 1/2 percent was granted to discounts secured with Government securities.<sup>10</sup> Banks became quite willing to purchase Government securities because of their liquidity.

After the war the prevailing inflexible monetary policy was becoming a troublesome problem. During World War II, yields and prices of Treasury securities had been stabilized in a situation in which investors had few or no alternative outlets for their money. Since post-war business was booming

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<sup>7</sup>Ibid., p. 19.

<sup>8</sup>Board of Governors of the Federal Reserve System, Federal Reserve Bulletin, January, 1948, p. 16.

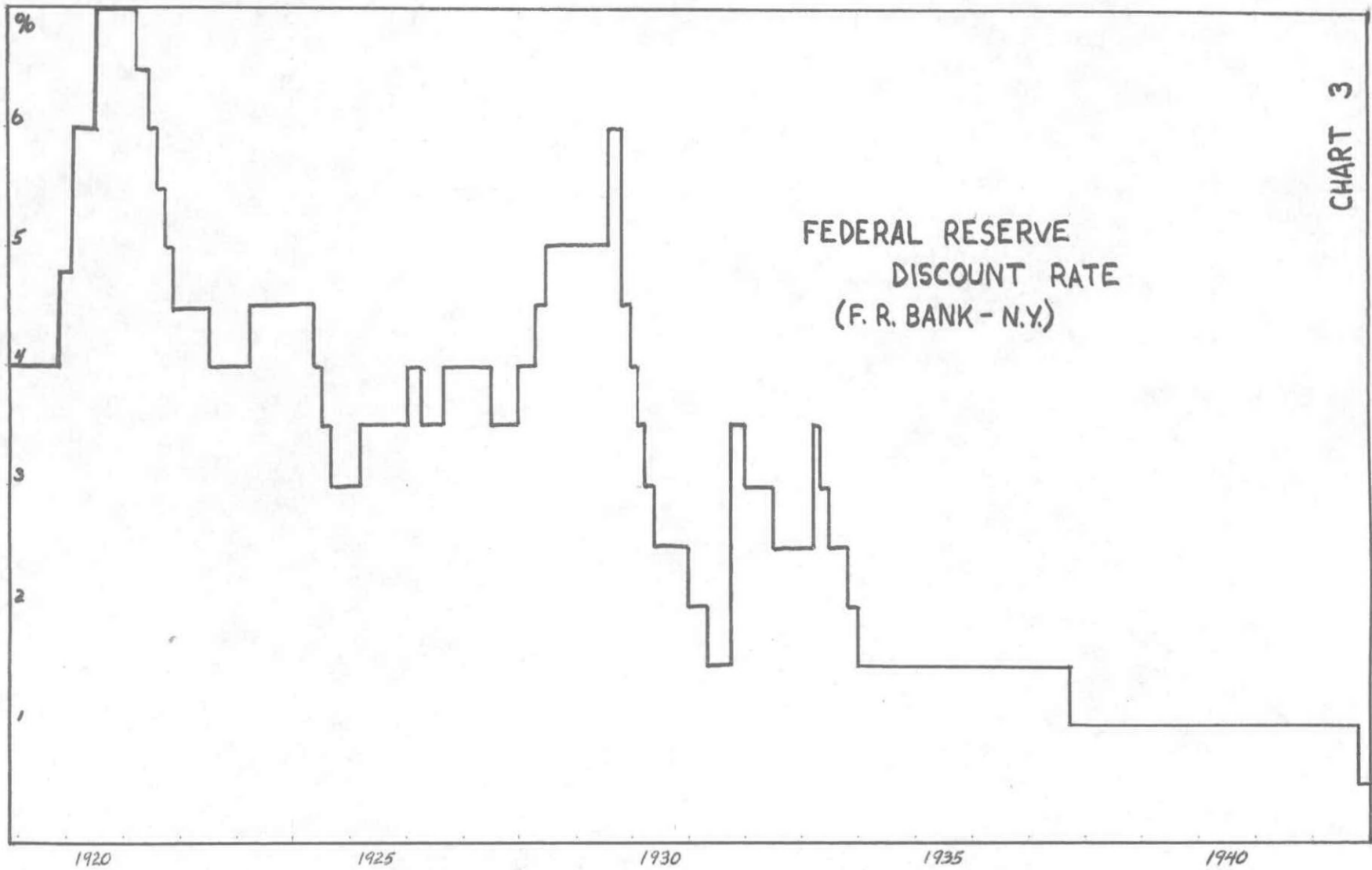
<sup>9</sup>Ibid.

<sup>10</sup>The discount rate charged by the Federal Reserve is displayed in graphic form in Chart 3.

and investment opportunities were widespread, pegging Government securities prices and yields not only prevented the Federal Reserve Board from using its power to limit inflation, but became an inflationary force itself.

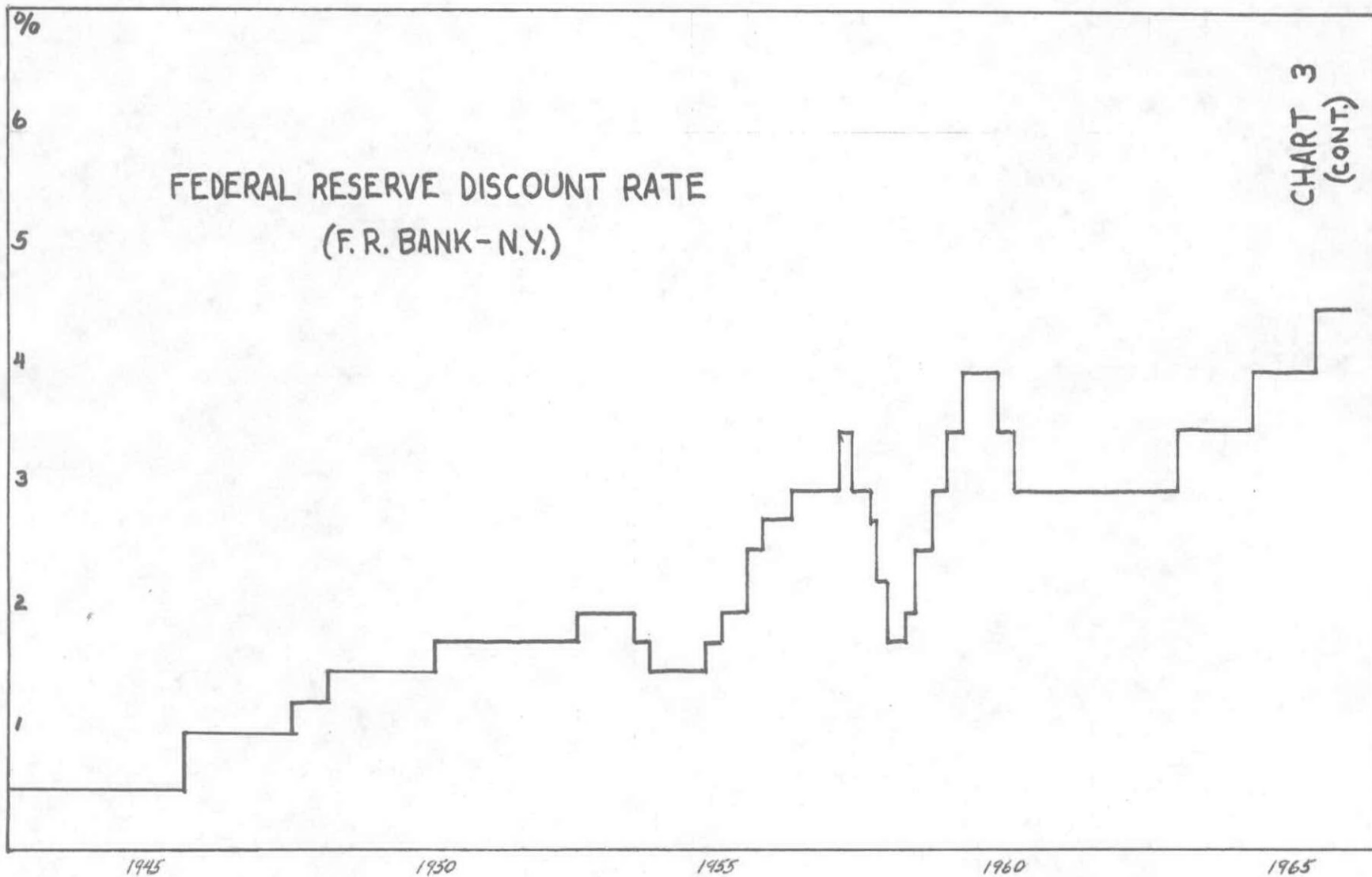
At the same time the Treasury was pressing for stabilized interest rates to maintain a ready market for Government securities. The situation was finally resolved in the Treasury-Federal Reserve accord of 1951 which permitted the Federal Reserve to pursue a flexible monetary and credit policy as needed to influence appropriately the general economic situation.

Since 1951, the Federal Reserve System has followed a fairly vigorous and flexible policy concerning its use of the discount rate as a credit control mechanism.



SOURCE : FEDERAL RESERVE CHARTS ON BANK CREDIT, MONEY RATES, AND BUSINESS, OCT 1949, P. 26-27





SOURCE : FEDERAL RESERVE CHART BOOK ON FINANCIAL AND BUSINESS STATISTICS, MAR 1966, P. 23

### Chapter Three

#### WHY BANKS BORROW

The discount rate is a credit control mechanism because banks tend to borrow more when the rate is high and borrow less when the rate is low. This is the case because, in the banking system as a whole, the general economic conditions which invite a hike in the discount rate are the same conditions which lead banks to borrow. That is, in boom times there is a great demand for credit by the public and banks often must borrow to meet that demand and still maintain their reserve position; to curb inflation in these boom times, the Federal Reserve might raise the discount rate. Later when business activity drops off and the demand for money is not so great, banks are no longer under as great a pressure to borrow. If this falling off of activity persists the Federal Reserve might take appropriate steps to halt the decline and, among other things, lower the discount rate.

In keeping with the "need" theory of borrowing, banks are most concerned with the relative costs of borrowing from the Federal Reserve as compared with the costs of alternative sources of funds. When adjustments to their reserve position are necessary to maintain the legally required reserve, the absolute cost of obtaining the funds is immaterial. Examples of alternative funds available to banks are: the sale of Government securities and the purchase of Federal funds. A bank needing funds is more apt to sell securities if the rate of return on them is below the discount rate; likewise Federal funds would be an attractive source when the Federal funds rate is low.

To illustrate that profit is not the dominant factor influencing borrowing by member banks, one need only look at the differentials between the discount rate and other applicable interest rates in the economy. The very fact that there is a differential indicates that profit is not the dominant factor influencing borrowing; the profit motive would attract money towards and away from the market in just the right proportions to eliminate the rate differential.

Bankers generally feel a need to supply a certain amount of credit to the banking public in good times and bad; in tight money times a banker might have to borrow. To a great extent the level of borrowing by member banks is a reflection of conditions which have had an effect on the reserve position of the borrowing banks. Conditions which might cause a drain on reserves and a subsequent reason to borrow are: excessive withdrawals of demand deposits or substantial loan increases. These demands for funds often take precedence over short-run profit motives; even a banker feeling no special compulsion to supply credit to his community in tight money times must meet all legitimate withdrawals of demand deposits.

Because member banks borrow in response to drains on funds and because of their reluctance to remain in debt for extended periods, the volume of borrowing at any one time "constitutes one of the most important single factors in money rate fluctuations . . ."<sup>11</sup>

It has not been intended to purport that cost is not significant to a banker who must somehow acquire more funds; it is. What has been intended is to suggest that the banker will seek that source of funds which will, in

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<sup>11</sup>George N. Halm, Economics of Money and Banking, Homewood, Illinois: Richard D. Irwin, 1956, p. 119.

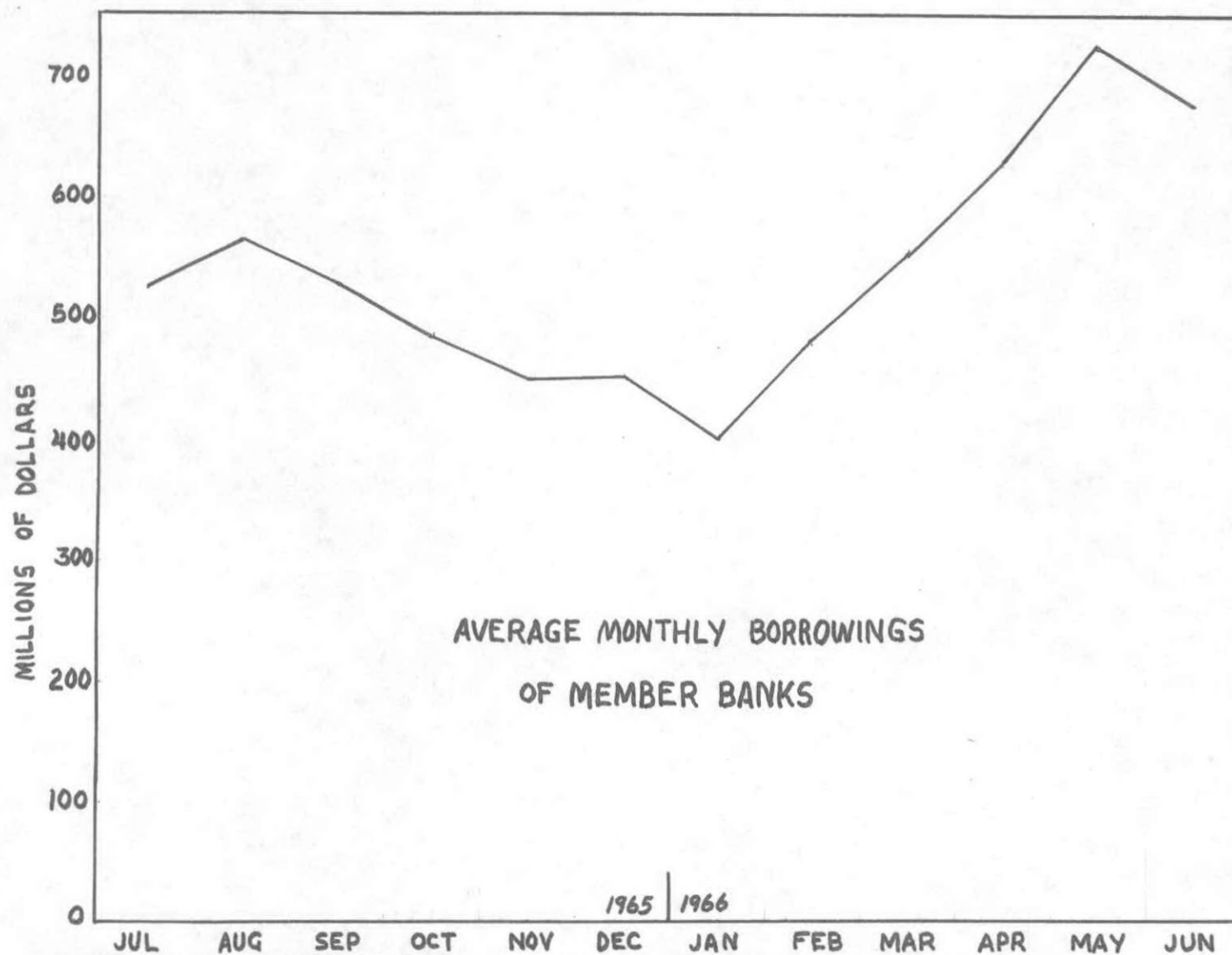
the long run, be most beneficial, whether that source is borrowing from the Federal Reserve, borrowing from some other source or disposing of some assets. Most bankers do not like to remain in debt for extended periods and the longer they remain in debt the more determined are their efforts to rearrange their asset structure to fit their changing needs.

The seasonal volume and timing of borrowing of the banking system as a whole does not necessarily coincide to the needs of an individual bank. The over-all pattern of business activity is generally stronger in the fall with a peak at Thanksgiving and Christmas; it then slacks off until midyear except for the Easter season.

In an agricultural community, however, a banks deposits will increase during harvest reaching a peak at about Thanksgiving and then slowly decreases as the community pays out for living expenses. Then as planting time nears, the banks will increase their loans to meet the seasonal demand for money for the crop.

When demand deposits are up in November and December the demand for credit by bank customers is also low. During this period, banks generally have excess reserves and as indicated by Chart 4, bank borrowing is at its lowest. Likewise, as bank deposits decline in spring and early summer, the demand for credit by customers increases and bank borrowing increases also. As indicated by Chart 4, again, bank borrowing peaks out in May or June.

CHART 4



SOURCE: FEDERAL RESERVE BULLETIN, VOL 52, NO 7, JULY 1966, P. 988

## Chapter Four

## TRADITION AGAINST BORROWING

One of the more interesting facts associated with member bank borrowing from the Federal Reserve is the incidence with which banks borrow; some banks just do not borrow at all; others borrow in varying degrees ranging from seldom to regularly to heavily. Some banks borrow so regularly and heavily that the Federal Reserve sometimes finds it necessary to take direct action with the bank in question to discourage its continuous use of the discount facilities.

In the United States it has always been traditional banking practice to avoid indebtedness for extended periods. Much of the Federal Reserve's discount policy is predicated on this tradition and a constant pressure is placed on those indebted banks to reduce or eliminate their borrowing. At the same time banks tend to reduce their debt regardless of the discount rate, by calling loans, selling securities or not renewing loans.

"The discount mechanism, while supplying reserve funds temporarily, tends to discourage undue expansion of bank credit. While banks are in debt, they are under pressure to repay and hence are likely to be conservative in expanding their own loans. Even when the total borrowing of all member banks is constant, a changing group of individual banks will be borrowing and will be feeling the need to restrict credit in order to adjust reserves. The restrictive influence of this pressure spreads beyond individual requests for bank credit and affects the attitudes of businesses and consumers throughout the community."<sup>12</sup>

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<sup>12</sup>Board of Governors on the Federal Reserve System, Thirty-Ninth Annual Report Covering Operations for the Year 1952, Washington, 1953, p. 5.

Borrowing by banks under normal conditions came to be considered almost synonymous with an overextended position.<sup>13</sup>

Apparently the tradition against borrowing was a reality in the United States before the establishment of the Federal Reserve System. As Burgess phrased it " . . . in the old days the bank which borrowed largely and continuously from its correspondents was looked upon with suspicion . . ."<sup>14</sup>

This tradition against borrowing was substantiated during the early days of the Federal Reserve System. In 1920 and 1921 when the Federal Reserve first really applied a restrictive policy and increased the discount rate to as much as 7 percent, many banks were heavily in debt to the Federal Reserve banks. For a few months during this period, some of the Federal Reserve banks even applied a progressive rate structure against those banks who were the heaviest borrowers, thereby throwing an even heavier burden on those banks. Borrowing was discouraged.

Many banks, during the depression, in trying to meet the demand for withdrawals, exhausted their borrowing potential and were forced to close their doors because of lack of liquidity. Most of these banks had good solid assets but weren't able to liquidate them fast enough to meet the demand and had to close their doors. These same banks in many cases later paid off all customers 100 cents on the dollar after their assets were liquidated. In the meantime, however, the unpleasant experience associated with borrowing was

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<sup>13</sup>Lester V. Chandler, The Economics of Money and Banking, Revised edition, New York: Harper and Brothers, 1953, p. 323.

<sup>14</sup>W. Randolph Burgess, The Reserve Banks and the Money Market, Revised, New York: Harper and Brothers, 1946, p. 219.

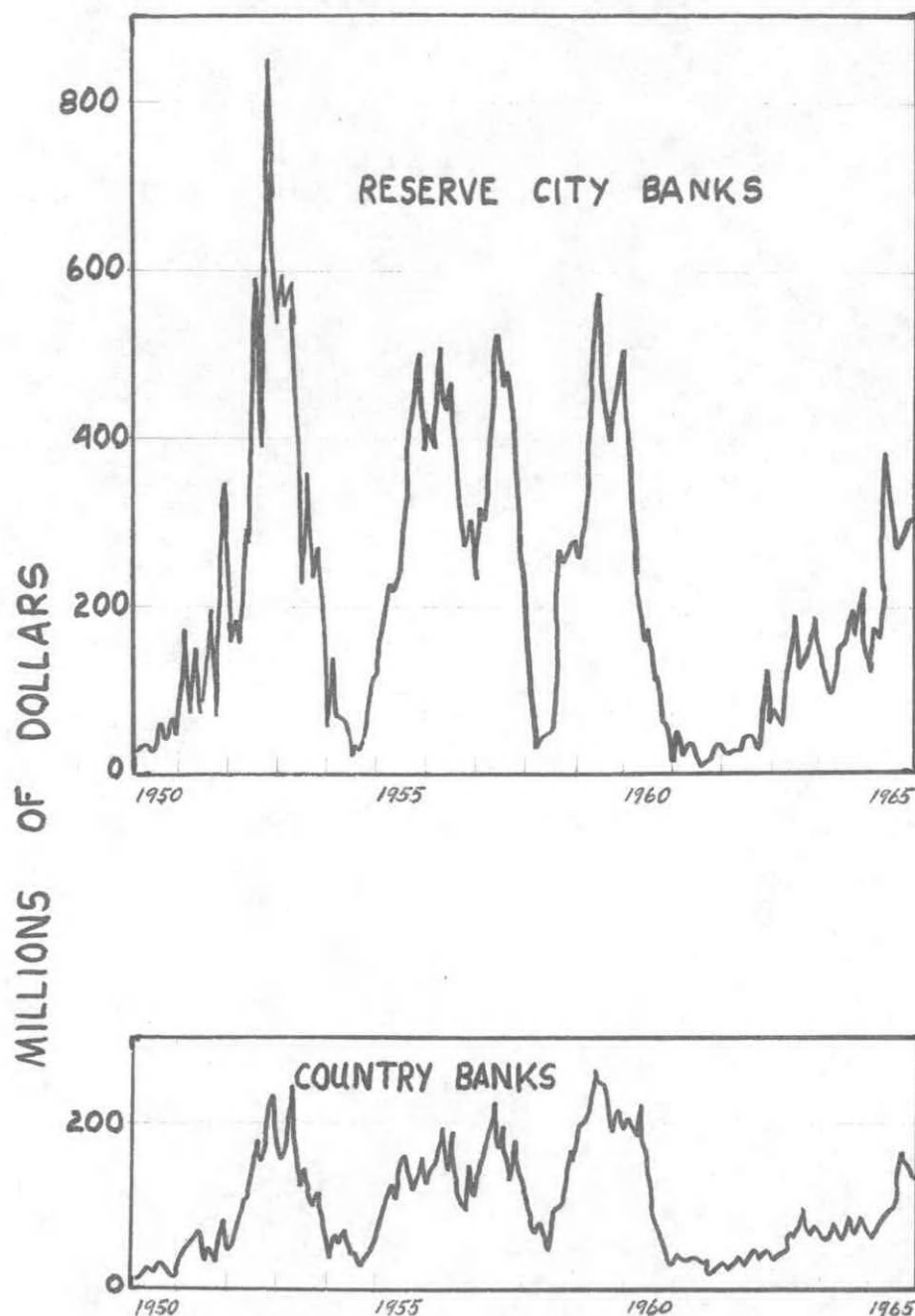
so unfortunate that by 1934 the tradition against borrowing could almost be described as a phobia.<sup>15</sup>

With such a strong tradition built up against borrowing, banks made less and less use of the discount mechanism; as time went by the disuse made the traditional almost a forgotten part of the past. Of what possible significance is a tradition against borrowing when the only occasion for borrowing is in nominal amounts for pure convenience and when the borrowing bank is in a position to repay the loan at any time with little or no inconvenience?

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<sup>15</sup>McKinney, Op. Cit., p. 41.





**BORROWINGS OF MEMBER BANKS FROM FEDERAL RESERVE**  
(MONTHLY AVERAGE OF DAILY FIGURES)

SOURCE: HISTORICAL CHART BOOK,  
BOARD OF GOVERNORS OF F. R., 1965, P. 7

CHART 5

## Chapter Five

## ALTERNATE SOURCES OF FUNDS

Many banks consider the discount mechanism of the federal reserve to be a last resort to obtain needed funds, and, instead rely on other sources of funds as much as possible. In recent years, the same pressures which have led member banks to become more familiar with the discount mechanism have also caused them to become more familiar with alternative sources of funds.

One of the most interesting borrowing techniques to develop in recent years has been the Federal Funds Market.<sup>16</sup>

Although called a "purchase" or "sale" of Federal funds, the transaction is in effect a loan of funds immediately available at the Federal Reserve Bank. Typically, it is an overnight loan (except for holidays and weekends). Therefore it is best suited to large banks which try to keep their funds fully invested and adjust their reserve position daily. The lending bank advances funds "sold" by instructing the Federal Reserve Bank to transfer them to the borrowing bank's reserve account for immediate credit. The borrowing bank makes the repayment by effecting a transfer to the reserve account of the selling bank on the next business day. Generally these are telephone transfers confirmed in writing.

Federal funds are sold at rates which can fluctuate very rapidly as supply and demand factors change; the rate shows wide savings in a single day. However the discount rate sets a fairly effective ceiling on the Federal

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<sup>16</sup>Woodworth, Op. Cit., p. 53-65.

Funds rate, and as the rate approaches that level it became more a question of availability of Federal funds than a question of price.

Federal Funds are generally sold in blocks of \$1 million or more; but in the case of small banks, transactions may be half or a quarter of this sum.<sup>17</sup> This size limitation (together with the very short-term nature of the transaction) means only the large banks can actively participate in the Federal Funds market.

This has probably been one of the factors which led to the establishment of the market in repurchase of Governments (and municipals) because small banks also need a source of short-term funds and a short-term outlet for excess funds. Here again the term "sale" and "repurchase" are used in place of "lending" and "borrowing"; however, the terms mean exactly the opposite of what they mean in Federal Funds transactions. The borrowing bank will "sell" Government securities to the lending bank under an agreement to "repurchase" them at a stated time and price. There is no risk of price fluctuations since the purchase and sale are at prices stipulated at the time of the original transaction and are not necessarily closely tied to market prices.

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<sup>17</sup>Ibid., p. 55.

## Chapter Six

## ELIGIBLE PAPER

A bank may have occasion to utilize collateral other than Government securities and many times must determine if the other collateral is "eligible paper" as defined in section 13 of the Federal Reserve Act. Eligible paper is generally: (1) commercial paper, (2) of short maturity and (3) is non-speculative in nature.

Commercial paper consists of notes issued by businesses and is "created in the process of financing the flow of commodities in production and trade (and) arises out of loans that are ordinarily liquidated by the borrower with funds received in the natural course of events from the sale of goods underlying the transaction."<sup>18</sup>

It was thought, in the early days of the Federal Reserve System that loans of this self-liquidating variety should be encouraged; these self-liquidating loans were thought to be automatic credit and economic stabilizers. Commercial paper was supposed to end bank failures.

Commercial paper is no longer thought to be a guarantee against failure. A lesson learned in the 30's was that many businesses were unable to repay loans of this self-liquidating variety since the commodity representing the loan was sold often at a loss or not at all. Businesses were unable to pay back their loans because they couldn't sell their merchandise.

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<sup>18</sup>Board of Governors of the Federal Reserve System, Federal Reserve Bulletin, Washington D. C., Vol. 16, No. 7, July, 1930, p. 401.

It is realized that a bank must, within the limits of its resources, meet all legitimate demands for commercial loans if it is to perform its basic function to the community; and bankers are normally happy to make sound loans of this type. However, a bank which makes only commercial (self-liquidating) loans could find itself unable to collect on those loans in hard times such as experienced during the depression.

Eligible paper was conceived at a time when rediscounting by member banks was expected to be the main source of borrowed funds for commercial banks. The discount function was to serve as a cushion to protect the individual bank against short-term or unusual pressures. An undesirable and unnecessary element of inflexibility is introduced if the Federal Reserve Bank were to accept long-term paper as collateral. No useful purpose would be served by rediscounting paper of long maturity. Therefore, short-term paper was made a requirement for paper to be eligible.

The function of the central bank as a lender of last resort requires that it be willing and able during times of crisis to create the liquidity needed by the banking system. The requirement that only short-term paper be used to secure advances does not show the same logic that it does in the case of rediscounts. Advances are notes with their own maturity and the maturity of the collateral should be of no consequence. If the **short-term** requirement restricts the Federal Reserve's ability to lend on advances, then the Federal Reserve cannot provide the necessary liquidity in time of crisis.

It has been said that eligible paper must represent non-speculative ventures. The paper used to secure the loan must be of a non-speculative

nature, but the use of the proceeds of the loan for speculative purposes can be controlled only by restricting the total amount of borrowing by a member bank.

One of the acts recognized early by the Federal Reserve System was that the use of borrowed funds does not depend on the nature of the collateral used in obtaining them. Paper offered may disclose the purpose for which the loan evidenced by that paper was made, but it does not disclose what use is to be made of the proceeds of the rediscount.<sup>19</sup> A farmer's note may be offered for rediscount by a member bank when in fact the need for rediscounting has arisen because of extensions of credit by the member bank for speculative use. Commercial banks may make speculative extensions of credit as easily while borrowing on ninety-day commercial paper as while borrowing on paper secured by stocks. The nature of the collateral used is largely irrelevant.

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<sup>19</sup>Board of Governors of the Federal Reserve System, 1923 Annual Report, Washington D. C., p. 35.

## Chapter Seven

## HOW BANKS BORROW

From the inception of the Federal Reserve System until September, 1916, the only avenue available to banks for borrowing from the Federal Reserve was through the discount mechanism. At that time the provisions of the Federal Reserve Act were amended to permit the use of advances secured by eligible paper and Government securities; maturity was not to exceed 15 days.

Advances are basically a promissory note issued by the bank and secured by notes of the bank's customers. Advances are normally in round figures and can be secured by notes of varying maturities. A customer need never know that his note was used to secure a loan (advance) for the bank.

Because of the greater convenience involved in borrowing on advances rather than on rediscounts, member bank borrowing on advances increased rapidly. Since the mid-1930's there has been practically no use of rediscounts.<sup>20</sup>

During the first two decades of the Federal Reserve System most bankers kept a close inventory on the amount of eligible paper they held; this would insure ample securities in the event they wanted to borrow. Frequently, a bank's loan policy was aimed at maintaining some minimum relation between the amount of eligible paper held and total loans outstanding. When borrowing declined in the 1930's, however, the concept of eligible paper fell by the way for the most part.

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<sup>20</sup>George W. McKinney, Jr. The Federal Reserve Discount Window Administration in the Fifth District, New Brunswick, New Jersey: Rutgers University Press, 1960, p. 56.

As a result, when increased pressures to borrowing developed again in the early 1950's, banks found themselves generally unfamiliar with the techniques of borrowing from the Federal Reserve, and completely unfamiliar with both the concepts underlying and the techniques of handling eligible paper. But Government securities can also be used to secure advances and Governments were in ample supply; therefore the lack of familiarity with eligible paper had not really hampered most banks ability to borrow from the Federal Reserve. Government securities have now almost supplanted other eligible paper as collateral and has been found more convenient for several reasons: it is in large round denominations, it is readily available, and readily accepted as collateral.

The steps necessary to borrow from the Federal Reserve have been simplified. The borrowing bank sends only their executed note and the application form supplied by the Federal Reserve Bank. No covering letter or further explanation is required. The application form provides space for a description of the collateral and where it may be found. The note is dated as of the day it arrives at the Federal Reserve Bank and credit is given the borrowing bank on that same day, completing all necessary action on the part of the borrowing bank. When the note matures, the Federal Reserve Bank simply charges the borrowing bank's account for the amount of the note and it is repaid.

If banks must borrow quite unexpectedly they can arrange for the loan by telephoning the Federal Reserve Bank stating amount and maturity desired along with a description of the collateral; then the telephone conversation is confirmed by mailing in the required note and application. In this case the borrowing bank is credited with the proceeds of the loan on the day of the call and a dummy note is filed pending receipt of the executed note from the borrowing bank.



Most member banks keep a portion of their Government securities in safe-keeping at the Federal Reserve Bank. Others maintain their securities in their correspondent bank in New York and send the trust receipts, which represent the securities, to the Federal Reserve Bank. In either case the Federal Reserve Bank has physical control of the securities or trust receipts representing them; the Government securities are therefore readily available at the Federal Reserve Bank as collateral for member bank borrowing.

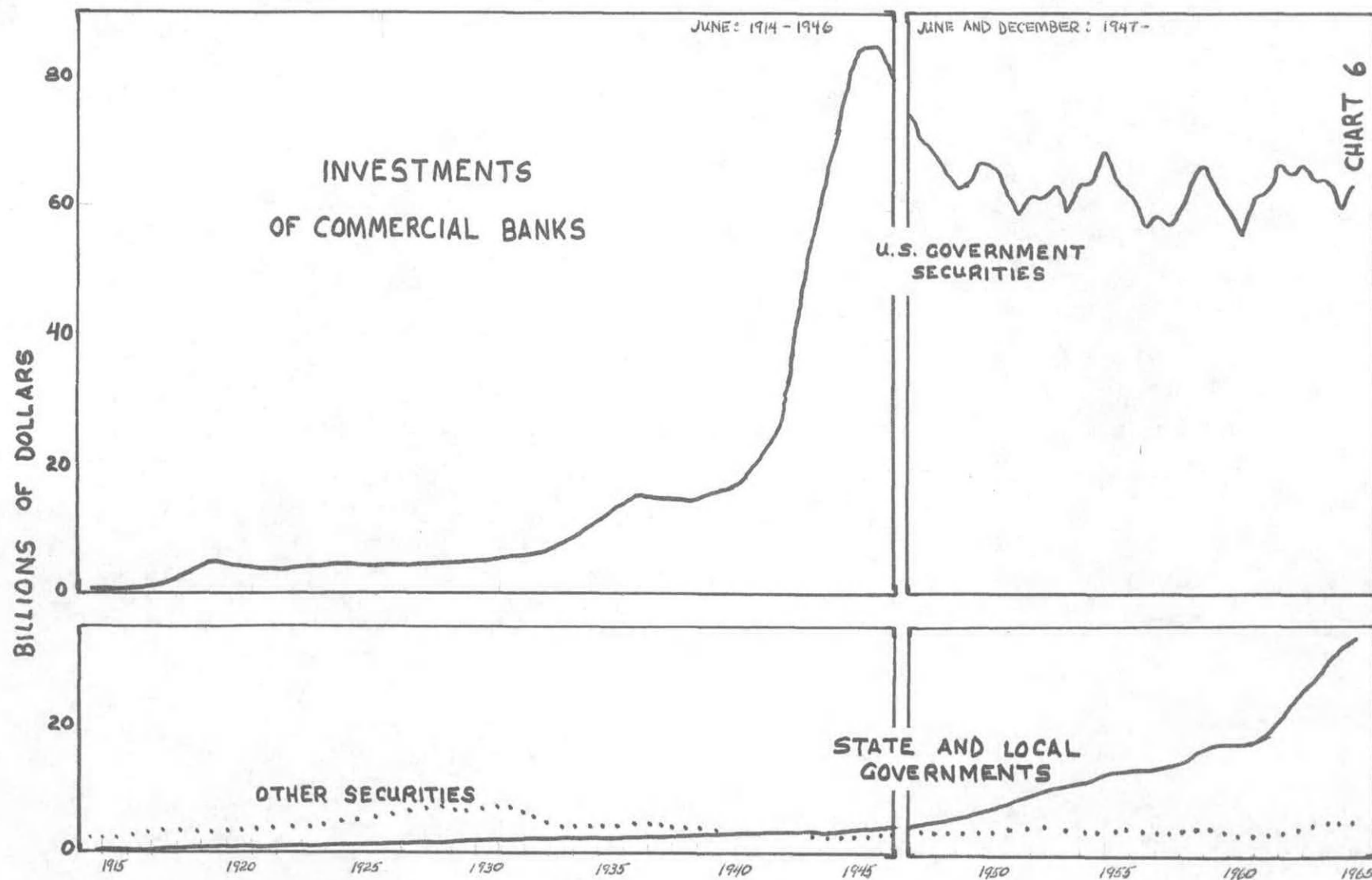
Procedures used in handling advances secured by eligible paper are similar to, but more complicated than, procedures used in handling advances secured by Government securities. The procedure becomes more complicated because the borrowing bank is required to certify that the paper offered as collateral is in fact eligible paper as described in section 13 of the Federal Reserve Act.<sup>21</sup>

A further complication for a bank securing an advance with eligible paper is that the bank must furnish current data on specified assets and liabilities. This additional requirement is made because it is generally considered to be much easier to secure an advance with Government securities; therefore a bank which is trying to secure a loan with eligible paper probably doesn't have any unpledged Government securities and is most likely already much in debt. The additional requirement gives the Federal Reserve Bank more information to analyze.

Furthermore, a bank borrowing on eligible paper must endorse that paper thereby making it obvious to the banks' customers that their notes were used to secure a loan for the bank. It is not really known just what customers'

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<sup>21</sup>Eligible paper as defined by the Federal Reserve Act is discussed more fully in Chapter Six of this paper.



SOURCE: HISTORICAL CHART BOOK, BOARD OF GOVERNORS OF F.R., 1965, P. 15

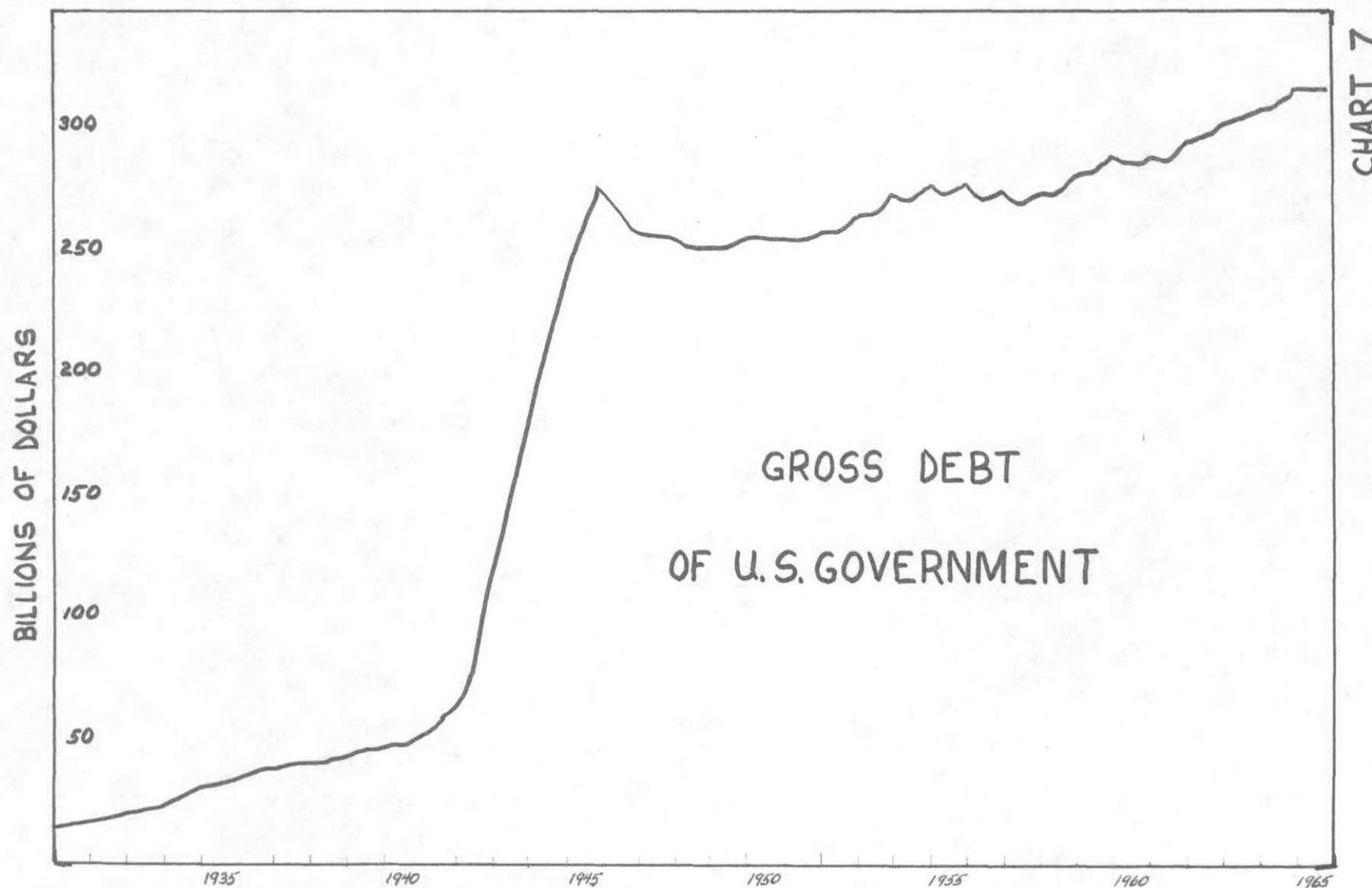
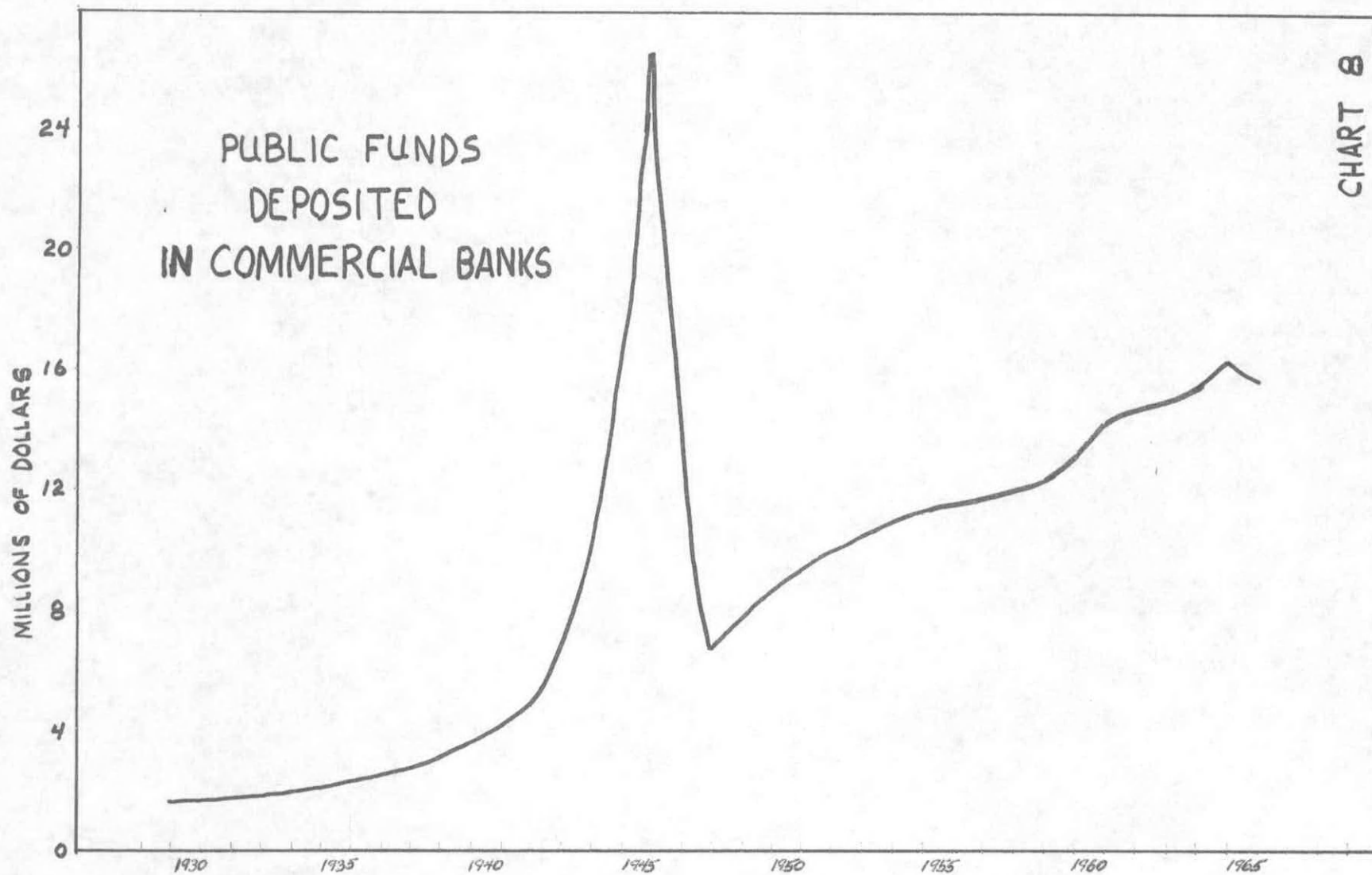


CHART 7

GROSS DEBT  
OF U.S. GOVERNMENT

SOURCE: HISTORICAL CHART BOOK, BOARD OF GOVERNORS OF F. R., 1965, P. 40



SOURCE : FEDERAL RESERVE BULLETINS - VOL 26, 1940 ; VOL 36, 1950 ; VOL 46, 1960 ; VOL 52, 1966

reactions would be to this but most bankers probably do not consider the risk worth the chance to find out.

As indicated in Chart 6, bankers have generally reduced holdings of the United States Government securities since 1945. Although this has not been a drastic decline it does represent some 20 billion dollars. United States Government securities held by commercial banks have declined despite an increase in the gross national debt as indicated in Chart 7. Commercial banks have reduced their holdings of Government securities in order to acquire funds to meet heavy loan demands. The interesting part of this trend, as it relates to member bank borrowing, is that it has sharply reduced the supply of United States Government securities which could serve as collateral.

Chart 8 shows that since 1947 holdings of public funds have been increasing. Not all public funds require the deposits of securities as collateral, but a substantial portion of public funds do tie up some of the banks' holdings of securities. Governments cannot be used for collateral to borrowings while they are pledged as security to public funds. Meanwhile the increase in business activity and in the amount of business done by banks has augmented their potential need to borrow. During much of this period a tight money market has brought additional pressure.

Over the past two decades, the member banks' holdings of Governments securities available for collateral to borrowings have been in a two-way squeeze. Not only have holdings of Governments declined but also the amount of Governments pledged against public funds has increased. As banks have been subjected to pressure toward additional borrowing, some individual banks have had to scramble to find free Governments to use as collateral.

If these trends continue, more banks will find the need to borrow on collateral other than Governments.

Chart 9 summarizes the various lending functions of the Federal Reserve that are available to member banks under present law. The Federal Reserve makes loans to other financial institutions besides banks who are members of the Federal Reserve System but the functions in Chart 9 include only those which apply to member banks.

## CHART 9

## LENDING FUNCTIONS OF FEDERAL RESERVE BANKS

(As authorized by regulations of the Board of Governors of the Federal Reserve System under provisions of the Federal Reserve Act and Defense Production Act.)

	<u>Maturity</u>
<u>Federal Reserve Act, Section 13;</u> <u>Regulation A</u>	
Advances secured by direct obligation of the United States (Par. 8, sec. 13) (covers virtually all borrowing)	fifteen days
Same as above except made only in unusual or extreme emergencies	ninety days
Advances secured by eligible notes, drafts, and bills of exchange	ninety days
Rediscounts of eligible notes, drafts, and bills of exchange	ninety days
<u>Federal Reserve Act, Section 13a;</u> <u>Regulation A</u>	
Rediscounts of agricultural paper	nine months
<u>Federal Reserve Act, Section 10b;</u>	
Advances secured to the satisfaction of the Federal Reserve Bank (Interest rate is 1/2 percent higher than the prevailing discount rate.)	four months

Source: George W. McKinney, Jr., The Federal Reserve Discount Window, New Brunswick, New Jersey: Rutgers University Press, 1960, p. 57.

## Chapter Eight

## CONCLUSIONS

In general the reluctance of member banks to borrow from the Federal Reserve has decreased in recent years. Given similar circumstances banks will now more readily turn to the Federal Reserve for funds than they would have in the decade following the depression of the 30's. We can expect the reluctance to borrow to weaken during periods when bank reserves are under greater pressure; and if this pressure on reserves is more or less continuing, member banks should become more familiar with the borrowing mechanisms and more willing to use them. Conversely during continuing periods of little pressure on bank reserves banks should become less familiar with borrowing and more unwilling to utilize the borrowing facilities of the Federal Reserve.

The implication of this seems to be that during prolonged periods of tight money when member banks become familiar with borrowing procedures and make more use of the borrowing mechanisms, the Federal Reserve will have to resort to direct action on specific member banks to avoid indiscriminate use of the borrowing facilities.

Member banks find rediscounting less convenient than borrowing on advances. One important difference is that an advance is in the amount and maturity needed, whereas it may be hard to find an eligible note of precisely the right size and maturity to rediscount. It is also easier for the Federal Reserve to handle records of advances since they would record one large note and list the collateral; whereas with discounting they would have to maintain separate records for each note discounted.



There appear to be several arguments for abandoning the concept of eligibility:

First, the concept was originally developed to accommodate the commercial loan theory of self-liquidating loans.

Second, the limit to any borrowing should be determined by the circumstances of the loan and not by the nature of the collateral.

Third, dividing collateral into "eligible" or "ineligible" does not mean that it is at the same time necessarily "safe" or "unsafe."

Fourth, bankers having an abundance of Government Securities pay little attention to the eligibility of their loans since the securities are much more convenient collateral anyway.

Fifth, most borrowing is on advances and the Federal Reserve looks to the bank and not the collateral for payment. Only if the bank fails would the collateral be called upon.

Sixth, the income from the 1/2 percent penalty rate under Section 10 (b) under normal circumstances is negligible. The cost of distinguishing in regulation and administration between eligible and ineligible undoubtedly exceeds the gross income derived from the penalty rate.

Seventh, banks pay more attention to convenience than to cost when borrowing.

Eighth, most of the claims that eligibility requirements have led to improvement in commercial banking standards are attributable to requirements that loans be liquid and sound, that adequate statements be furnished, and that customers' paper be subjected to careful review by the Federal Reserve Bank. With the exception of liquidity, these are requirements of acceptability, not eligibility.

Ninth, the real reason for allowing discounting is to achieve liquidity of the banking system in time of crisis. The concept of eligibility tends to limit the extent to which this can be done.

The concept of reliance on commercial paper is no longer thought of as the automatic credit regulation device. Nevertheless, banks are glad to make a certain amount of sound loans of the self-liquidating type where the need exists and they should be encouraged to do so. In practice, however, a bank in the United States today cannot and should not limit its credit extensions to short-term business loans.

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